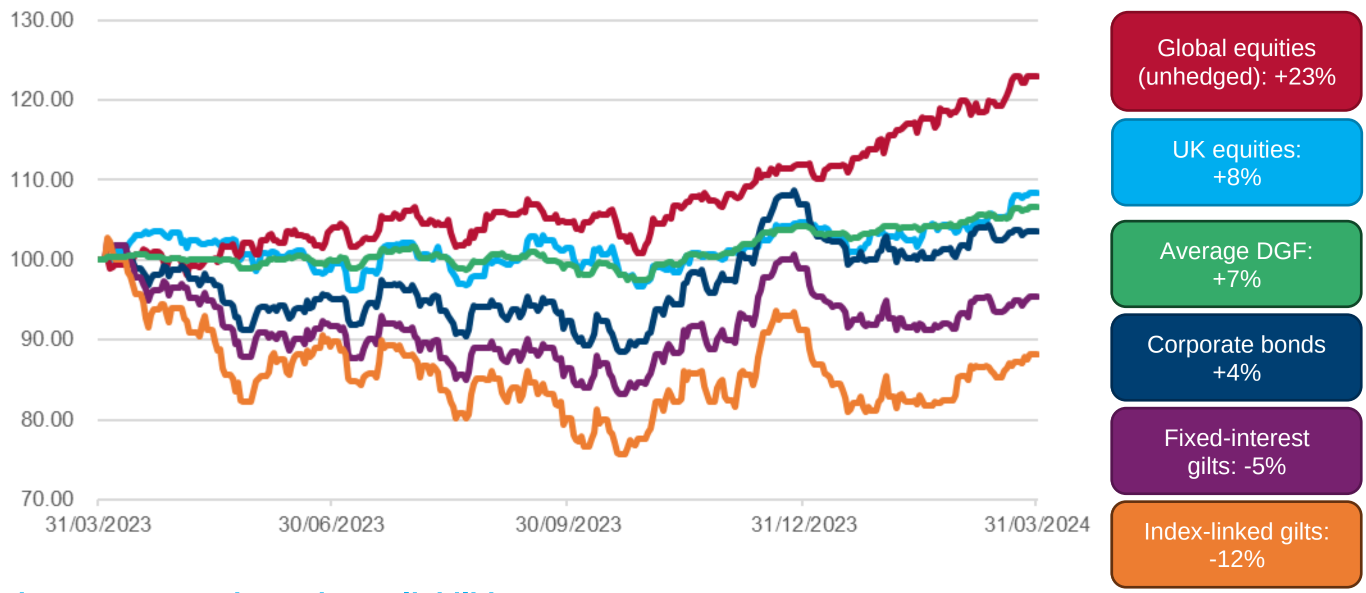
Employer pension briefing, Quarter 2 2024

In this briefing, we highlight key pension issues for employers. We focus on the impact of market movements on pension cost accounting positions and upcoming funding valuations. We also discuss broader developments in the pensions industry and how employers should be planning.

Changes in financial markets

Global equities have continued to be the standout performer, with returns of 10% over the quarter contributing to growth of 23% over the last 12 months. In a familiar story, UK equities have lagged somewhat, returning 8% over the year to 31 March 2024.

Government bonds have incurred losses of around 5% on fixed interest gilts and 12% on index-linked gilts over the year to 31 March 2024. Despite losses in Q1, corporate bonds have ended with a positive return of around 4% for the year, driven by falls in credit spreads.



Changes to pension scheme liabilities

It may seem obvious, but scheme asset performance should not be considered in isolation. Changes in scheme funding levels will reflect movements in both assets and liabilities.

Bond yields

Corporate bond yields are slightly higher than they were 12 months ago – with an average increase of around 0.1% pa. In isolation, this will have a small impact on accounting liabilities, reducing them by up to 2%.

Gilt yields, which tend to drive cash funding, low dependency and buy-out discount rates, saw more significant increases of around 0.5% pa. This will result in a fall of those liability measures based on gilt yields of up to 10%, and perhaps more importantly, those assets held to match gilts-based liabilities will fall by a similar amount.

Inflation

Inflation remains higher than the Bank of England's 2% pa target, although the rate of price increases does now look to be slowing. How much of this is due to monetary policy and how much is simply down to a higher baseline is difficult to say. Interestingly, long-term gilt market expectations of inflation do not foresee a fall below 3% pa over the next 40 years.

The extent of any change in your scheme's liabilities due to actual inflation and changes in expectations of future inflation will depend on the profile of the scheme and the caps and floors that apply to any inflationary increases.

Summary

The table below shows how the key financial assumptions have changed over the year:

	31 March 2023	31 March 2024	Impact on the liabilities of an average[1] scheme
Corporate bond yield[2]	4.7% pa	4.8% pa	-1%
Gilt yield[3]	3.5% pa	4.0% pa	-8%
Market-implied inflation[4]	3.7% pa	3.6% pa	-1%
Actual inflation (year to March 2024)	RPI: 4.3% CPI: 3.2%		*Scheme dependant*

1 An average scheme is taken to have a duration of 15 years and around 75% of liabilities linked to inflation
2 Yield on the iBoxx over 15-year AA-rated corporate bond index
3 Bank of England nominal gilt curve over a duration of 15 years
4 Gilt market-implied inflation at a term of 15 years from the Bank of England implied inflation curve

What does this mean for your scheme?

The impact on each scheme and liability measure will be different. Funding and buy-out liabilities may well have fallen, while accounting liabilities are likely to be relatively unchanged over the year. Asset performance will vary significantly depending on scheme-specific investment strategies.

Those schemes that retain a material exposure to equities are likely to have seen improved funding levels, while those that are heavily invested in gilts (or LDI) to hedge changes in funding liabilities may have seen their balance sheet position worsen due to the narrowing credit spread.

For more information on the implication on funding positions – especially if you have an upcoming actuarial valuation date – you might find our *Finance Director's guide to Defined Benefit pension scheme actuarial valuations as at 31 March 2024* useful. Ask your First Actuarial contact or request a copy.

Buy-out market update

The unprecedented increase in gilt yields over the past two years means that more schemes than ever are in a position to secure benefits with an insurer. The increase in demand has led to record volumes of risk transfer business being written. But with demand outstripping supply we are seeing capacity issues, and ultimately price increases, especially at the smaller end of the spectrum.

Relief is hopefully on the way, with several movements in the risk transfer provider market which should hopefully increase capacity:

IN: Royal London formally confirmed its entry into the bulk annuity market (having recently completed deals with two of its own schemes).

OUT: Scottish Widows is to sell its bulk annuity book to Rothesay Life and exit the market altogether.

IN (possibly): There are rumours that Utmost will enter the bulk annuity in the coming months.

IN (kind of): Clara recently completed its second superfund transaction with a £600m deal with the Debenhams Retirement Scheme (which was previously in a PPF assessment period following the insolvency of Debenhams).

IN (possibly, longer term): The DWP has consulted on introducing a public sector Defined Benefit (DB) consolidator (more below).

Of course, risk transfer is not the only answer for well-funded schemes, and you should consider all the options available before deciding if it's the right route for you and your scheme.

DB consultation central

Like buses, you wait a lifetime for a consultation on the future of DB pension schemes and then two come along at once, with both the Department of Work and Pensions (DWP) and The Pensions Regulator (TPR) having recently closed consultations on the subject.

DWP's consultation built on ideas introduced in the Autumn Statement about the introduction of a public sector DB consolidator and increasing flexibility for the distribution of DB scheme surpluses. Meanwhile, TPR consulted on its proposed *statement of strategy*, a key part of the new funding regime and an indicator of what might be required from those schemes looking to comply via the bespoke route rather than the fast track.

DWP (part 1): Treatment of scheme surplus

The Government is consulting on possible changes which would:

- Support investment in productive assets, by making it easier to share scheme surplus with members and employers
- Remove practical barriers to surplus extraction, such as those relating to scheme rules
- Remove behavioural barriers by bringing surplus extraction in line with trustee duties.

Possible changes include introducing a statutory override to allow schemes to make payments to employers when in surplus, and amending legislation to make it easier for schemes to provide one-off payments to members.

DWP (part 2): Model for a public sector consolidator

The Government is considering establishing a public sector consolidator, operated by the PPF, which would aim to provide an alternative end game solution for DB schemes that are unattractive to commercial consolidation providers.

This could be welcome news for very small schemes, and those with very complex benefit structures, which may struggle to find an insurer willing to take on their liabilities at a reasonable price.

TPR: Statement of strategy

The consultation focused on **TPR's proposed approach to the statement of strategy**, including the proposed form of the document, and the type and extent of the information to be submitted.

One key element of particular interest to employers is the additional information required for those schemes that will need to use the 'bespoke' route to comply with the new funding regime. This is our first glimpse of what the bespoke route will entail, and it's fair to say that the additional information that will need to be included is comprehensive, with around 50 additional questions for those following the bespoke route.

This extra information includes:

- Narrative explaining to what extent the funding and investment strategy remains appropriate and why
- Details of the scheme's current level of investment risk and how this has been determined
- Details on whether the scheme has an explicit interest rate or inflation-hedging target
- Details of the intended investment risk at the relevant date and how the scheme will de-risk
- Confirmation of whether professional covenant advice has been taken for this valuation, and if not, what experience the trustees have as a basis for assessing covenant
- Provision of free cash flows, investment in sustainable growth, shareholder payments and payments to other DB schemes for the previous, current and next year.

Across the industry, there is concern about the volume of information that schemes would be required to submit, particular for those using the bespoke route, so the finalised requirements may be less onerous.

Lifetime Allowance almost abolished

The Lifetime Allowance (LTA) tax charge was abolished from 6 April 2023, with the aim of removing the LTA from legislation from the start of the 2024/25 tax year. However, this has not gone to plan and HMRC's latest newsletter confirms that further regulations are required.

These additional regulations will be backdated to 6 April 2024. In the meantime, members who take their benefits may need to revisit their tax position and allowances later this year.

For further information, **read our LTA briefing**.

Get in touch with our experts

To discuss your scheme, contact your usual First Actuarial consultant or any of our **employer services team**.

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